CREDIT ENHANCEMENT FOR P3 INFRASTRUCTURE FINANCING IN INDONESIA

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A C R O N Y M S

ADB	Asian Development Bank
BOO	Build-own-operate
BOOT	Build-own-operate-transfer
BOT	Build-operate-transfer
BUMN	State-owned enterprise
CIDA	Canadian International Development Agency
CMU	Co-financiers' Memorandum of Understanding
DA	Development assistance
ESF	Economic support fund
GOI	Government of Indonesia
IFC	International Finance Corporation
I.M.F.	International Monetary Fund
IPO	Initial public offer
IPP	Independent power producer
JSX	Jakarta Stock Exchange
MIGA	Multilateral Investment Guarantee Agency
ODA	Official Development Assistance
OECF	Overseas Economic Cooperation Fund
P3	Public-private partnership
PPA	Power-purchase agreement
PSIDF	Private sector infrastructure development fund
RFP	Request for proposals
SOE	State-owned enterprise
SSX	Surabaya Stock Exchange
S&P	Standard & Poor's

EXECUTIVE SUMMARY

The dramatic changes that took place in Indonesia in May 1998 were accompanied by violence and tragedy. At the same time, the resulting political transitions offer a meaningful chance to change development policy implementation, especially in the infrastructure sector.

Before the crisis of 1997 and 1998, Indonesia was viewed as one of Asia's most promising emerging market countries. The government supported private sector participation in infrastructure, and the economy's strong fundamentals and potential resulted in an investment-grade rating of BBB/Stable for both the country and four infrastructure projects from Standard & Poor's, a leading rating agency. While the market's response was positive, investment was compromised by the country's weak regulatory framework and lack of transparency, fairness, and competitiveness. As a result, Indonesia had only realized a fraction of its potential to engage the private sector in providing infrastructure by the onset of the crisis.

Like many of its Asian neighbors, Indonesia lost its investment-grade rating in the wake of the region's economic crisis. The hurdle rate — the rate of return needed for a project to be acceptable to financiers — has increased significantly as risk levels have risen. With Indonesia's lower country rating, foreign banks may decide to reject potential public-private partnership (P3) projects that may be attractive on their own merits.

Indonesia's financial markets are not yet ready to play a major role in infrastructure financing. Local debt is short term, limited in quantity, and offered at high interest rates, partially the result of government efforts to maintain a stable rate of exchange. The high rates that prevailed for years encouraged Indonesian firms to borrow overseas. With an apparently stable exchange rate, most investors did not hedge their foreign debt exposure. This exposure played a major role in Indonesia's financial crisis, which deepened as foreign exchange markets scrutinized Indonesia's high levels of unhedged foreign debt. The resulting loss of investor confidence and drastic drop in the rupiah's value devastated the Indonesian economy. Another victim of the crisis was Indonesia's local equity market: newly emerged in the 1990s, market capitalization was nearly wiped out by the crisis, falling from $200 billion to about $15 billion. To play a meaningful role in financing P3 projects, Indonesia's financial markets need time to recover and rebuild.

With limited local financial markets and investor confidence severely shaken by the crisis, a key question emerges: how can Indonesian P3 projects obtain financing? One answer is to build on the linkages that exist between infrastructure financing, capital market development, privatization, and private pension plan development. Implementing a strategy that makes use of these linkages will support development goals over the long term as well as help meet short-term growth targets.

To meet its goals, Indonesia must to turn to international capital markets to finance P3 projects during the next two to five years. Given that foreign investors sustained major losses in the crisis, and the country has lost its investment-grade rating, this will not be easy. Indonesia needs to investigate techniques that have been used successfully in other non-investment grade countries to finance P3 projects. Many of these countries have economic fundamentals that are less sound, and long-term appeal less robust, than Indonesia. P3 projects *can* be financed in low-income, high-risk countries, provided projects are well structured and have strong, committed sponsors and political backing. The key to developing infrastructure financing in Indonesia is *credit enhancement* — improving a project's creditworthiness so it becomes bankable at reasonable interest rates. Doing this requires identifying the techniques that have worked in other locales and adapting them to succeed in Indonesia.

As shown in Exhibit 1 on the following page, the effective use of three key mechanisms enhances credit for P3 projects in risky countries. The judicious use of these mechanisms — project financing techniques, government support, and donor support — can help P3 project backers find financing even in depressed economies like Indonesia.

As depicted in Exhibit 1, project financing techniques used by private sector debt and equity participants form the central pillar of project financing, with government and donor support providing additional support. However, donor and government support may temporarily play a greater role at the beginning of a P3 program.

Project financing techniques. Private sector equity and debt participants use project financing techniques to adjust and mitigate project risk. These techniques favor small projects, fast payback periods, high equity-to-debt ratios, foreign sourcing of debt, foreign exchange generation, escrow accounts, and mezzanine financing, especially subordinated and convertible debt.

Government support. Government support can be divided into two categories: program and project support. To provide program support, a government willingly adopts and implements a P3 program that is fair, transparent, and reflects international best practices. The second category, project support, must be used with care. Only those projects that are economically beneficial but cannot attract private sector financing at existing market rates should be candidates for project support. Projects that are not economically viable must be avoided at all costs. With strong P3 program support, there is less need for the government to provide financial support for individual projects.

P3 project support can take a variety of forms: tax holidays, low-cost benefits or cost sharing, performance guarantees, pricing tariffs and profit repatriation, and government subsidies and equity participation. The first four types of support can be useful; subsidies and equity participation, while frequently requested, should be avoided.

Donor support is the third pillar supporting P3 projects. USAID and the Canadian International Development Agency have taken the lead in promoting a P3 approach to infrastructure in Indonesia. Two other donors have played key roles in bringing non-investment grade projects to closure in Asia: the International Finance Corporation (IFC), the private sector-lending arm of the World Bank Group, and the private sector window of the Asian Development Bank (ADB). The Multilateral Investment Guarantee Agency, part of the World Bank Group, plays a role in supporting investment by providing political risk insurance to foreign investments in emerging market countries. It covers four types of foreign investment risk: expropriation, war and civil disturbance, currency inconvertibility, and breach of contract.

The World Bank itself also helps P3 projects become more bankable. In several countries the bank and other donors have channeled loan funds and guarantees through a private sector infrastructure development fund (PSIDF), which then makes loans and guarantees available to P3 projects. Typically these loans constitute 20 to 30 percent of a project's debt financing, with loan repayment terms longer than commercial bank loans. PSIDF participation allows faster repayment of commercial loans, reducing lenders' risk and increasing their interest in participation, especially with IFC or ADB backing.

Exhibit 1. Bankable P3 Projects

SECTION I

Financing Infrastructure Projects in Indonesia

A. Introduction and Background

The dramatic changes that took place in Indonesia in May 1998 were accompanied by violence and tragedy. At the same time, the resulting political transition has offered an opportunity to implement new policies, especially in the infrastructure sector.

A public-private partnership (P3) program for infrastructure that reflects international best practices is clearly a step in the right direction in getting Indonesia back on the path of economic growth. Attracting private sector financing for infrastructure will provide better services to consumers at a lower cost and release scarce budgetary resources for needed investments in social sectors such as health and education.

A1. Features of P3 Project Financing

A P3 program and project portfolio must attract financing from the private sector to be effective. A successful P3 project is *bankable* — raising debt financing to complement owners' equity to see the project through to completion and operation.

P3 projects have three basic financial features. While projects as small as $1 million can be undertaken, projects tend to be large, sometimes exceeding $1 billion for power, highway, and water supply projects in large cities. P3 projects are often highly leveraged, with debt usually representing 70 to 90 percent of total project financing. An infrastructure project typically has a longer investment period and operating life than an industrial project. As a result, infrastructure debt requires fairly long maturities, often 15 years or more, corresponding to projects' economic life and payback period.

A P3 project requires a balance of financial interests between project owners, lenders, the host government, and infrastructure service consumers. The host government must be prepared to offer a competitive rate of return to investors and private lenders on P3 projects. However, as arbitrator between P3 project providers and consumers, the government should focus on providing services to consumers at a reasonable cost rather than limiting the private sector to a specific rate of return. A high-profit/low-cost bid serves the public interest better than a high-cost/low-profit bid.

These observations underscore the fact that P3 infrastructure project financing is perhaps the most complex financing of all to bring to closure. Raising large amounts of capital to finance infrastructure is challenging in developed countries. In emerging market countries such as Indonesia, this challenge is compounded by limited local capital markets and foreign financiers' apprehensions of instability and risk. These difficulties have increased with the Asian economic crisis and the events of May 1998, which have heightened investors' perception of risk.

To overcome these constraints and attract private sector financing at reasonable interest rates, the government must use a menu of techniques to enhance project creditworthiness. These techniques are discussed later in this section.

A2. Activity Streams in Indonesia's P3 Program

This report addresses the legal, regulatory, and administrative prerequisites for a successful P3 program. These factors — the foundations on which P3 project financing stand — determine a project's success.

Implementing a P3 program for infrastructure that reflects international best practices requires four main activity streams. As depicted in Exhibit I-1 on the following page, these streams are:

- Develop relevant agency and ministry capacity to implement a P3 program, using tools including a manual, conferences, and training
- Create a pipeline of projects suitable for a P3 approach
- Improve the country's regulatory framework
- Develop credit enhancement techniques for financing P3 projects

These four interrelated activity streams should proceed in parallel. Long lead times are needed to market a P3 program to the investment community, address investors concerns, and design credit enhancement vehicles that facilitate P3 project financing. The finance and credit enhancement component, in particular, must be initiated as early as possible in the program. It is this activity — credit enhancement — that prepares the P3 program to meet the market's ultimate test: Will foreign and local investors be willing to invest hundreds of millions of dollars in Indonesia?

A3. Relation of P3 Program to Overall Economic Strategy

Developing a P3 program that reflects international best practices will play a decisive role in reviving the Indonesian economy. The P3 program will benefit greatly by Indonesia's early return to macroeconomic stability; once up and running, it will help maintain stability by easing government budget constraints and inflationary pressures. Together with other reform measures, the P3 program will help restore local and foreign investor confidence, spurring new investment, promoting growth, and providing much-needed jobs. The relationship of the program to Indonesia's economic strategy is illustrated in Exhibit I-2.

Developing local financing for P3 projects is linked to other reform program measures to turn Indonesia's economy around and help it achieve sustainable growth. These measures, which include developing capital markets, privatizing SOEs, and developing private pensions, are discussed in more detail in Section II.

B. Indonesia's Economic and Financial Environment Before the Crisis

In the mid-1960s, Indonesia was poorer than India[1]. Policies supporting macroeconomic stability, high rates of savings and investment, an outward-looking trade regime, and the development of human capital led to real growth rates that averaged more than 6 percent a year for the last three decades. This performance placed Indonesia in the top 10 percent of emerging market countries. Before the crisis,

[1] This section draws heavily on "Indonesia: Sustaining High Growth with Equity," World Bank, 1997.

Indonesia’s savings and investment rates constituted more than 30 percent of its GDP. These high rates placed Indonesia among the top counties in the BBB rating category,

Exhibit I-1. Strategy for P3 Projects and Reform in Indonesia

Exhibit I-2. Strategy for P3 Projects and Reform in Indonesia

helping it sustain annual GDP growth rates of 7 to 8 percent, as shown in Exhibit I-3. By the mid-1990s, Indonesia's per capita GDP topped $1,000, or more than three times that of India.

Exhibit I-3. Real Growth in GDP in Indonesia

Year	Percent
1988-1991	9.0
1991-1994	7.3
1995	8.2
1996	7.8

This economic setting attracted foreign and domestic investment. By the mid-1990s, Indonesia had one of the world's highest investment rates, fueled by capital inflows and high domestic savings. It also enjoyed a surge of local and foreign investment, shown below in Exhibit I-4.

Exhibit I-4. Approvals of Foreign and Local Investment

Year	U.S.$ (billions)	Rupiah (trillions)
1990-1993 (average)	9.0	42.4
1994	23.7	53.3
1995	39.9	69.9
1996	29.9	100.7

Source: World Bank

Before the crisis, Indonesia's economy was characterized by the following underlying strengths:[2]

- Strong real growth
- Decreased overall inflation
- Robust direct foreign investment
- A manageable external current account
- Macroeconomic policies that appeared sound
- Government commitment to prudent fiscal management

But observers also noted constraints that could cause future problems if not addressed:

- High core inflation
- Increasing private external debt
- Growing dependence on volatile capital flows
- Substantial infrastructure development needs that remained unmet
- Adverse developments in neighboring countries that could spill over into Indonesia
- A need to place greater reliance on the private sector through privatization
- Banking system weaknesses

[2] These points are summarized from"Indonesia: Sustaining High Growth with Equity," World Bank, 1997, and "Global Project Finance," Standard & Poor's, 1997.

- Domestic trade regulation and import monopolies that imposed structural rigidities

To return GDP and investment rates to pre-crisis levels, the Indonesian economy must stabilize and deregulate. The government must also develop a transparent framework for P3 projects in infrastructure, expected to account for much of Indonesia's new investment.

C. Role of Infrastructure in the Economy

As noted above, infrastructure inadequacies constrained Indonesia's economy even before the crisis hit. Below, we examine the role of infrastructure in Indonesia's government budget and economy. As Exhibits I-5 and I-6 illustrate, infrastructure has accounted for a significant percentage of Indonesia's development expenditures throughout the 1990s.

Exhibit I-5. Development Expenditure by Sector

Sector	Expenditures: 1989/1990-1993/1994	Expenditures: 1994/1995-1997/1998
Agriculture, Forestry, Irrigation, and Water Resources	13%	10%
Human Resource Development	14%	14%
Physical Infrastructure	31%	34%
Regional Development and Transmigration	15%	19%
Others	27%	23%
Development Expenditure as Percentage of GDP	8.1%	6.8%

Source: World Bank

Exhibit I-6. Breakdown of Expenditures on Physical Infrastructure

Physical Infrastructure	Expenditures: 1989/1990-1993/1994	Expenditures: 1994/1995-1997/1998
Roads	12%	12%
Energy	11%	12%
Other Transport	7%	7%
Post and Telecommunications	1%	3%
Total Physical Infrastructure	31%	34%

Source: World Bank

These figures show that the percentage of Indonesia's development budget dedicated to infrastructure grew through the 1990s. However, as shown in the final item in Exhibit I-5 — Development Expenditures as a Percentage of GDP — overall development expenditure declined in the 1990s as a percentage of GDP, falling from 8.1 percent in 1989/1990 to 1993/1994 to 6.8 percent in 1994/1995 to 1997/1998. In other words, Indonesia's rate of expenditure on infrastructure has not kept up with economic growth. The World Bank estimates that Indonesia needs to increase investment in infrastructure by at least 1 percentage point of GDP.

Demands on Indonesia's development budget are growing, particularly from social dislocations caused by the crisis including loss of jobs. A P3 approach that includes private sector participation in infrastructure financing can help meet the country's growing need for infrastructure and free development budget resources for other needs. Private sector involvement in building and financing infrastructure also provides jobs, helping relieve social stress.

Indonesia was able to take advantage of the worldwide public-private partnership movement to attract private sector financing for infrastructure during the 1990s. It made significant progress in power and telecommunications, and private participation has grown in toll roads, water supply, and ports. Repelita VI (1994/1995 to 1998/1999) set out policies for private sector participation in infrastructure development, although practices often did not conform to international best practices. The equivalent of $200 billion in infrastructure investment was scheduled for the 10-year period ending in 2004, with the private sector accounting for a significant portion of the sum.

C1. Infrastructure in Indonesia: Viewpoint of International Capital Markets

Most debt financing for P3 projects is done through syndicated bank loans, export-promotion banks such as the U.S. Export-Import Bank, and groups such as the Overseas Private Investment Corporation (OPIC). Banks and trade and investment agencies have guidelines for assessing country and project risk and prospects, and reaching decisions on financing projects. Bond ratings indicate how international capital markets view particular countries and projects.

Indonesia, in particular, was regarded as one of Asia's most promising emerging market countries before the onset of the 1997/1998 crisis. The government supported private sector participation in infrastructure, and the economy's strong fundamentals and potential resulted in an investment-grade rating of BBB/Stable for the country from Standard & Poor's (S&P), a leading rating agency.

Indonesia's investment-grade rating helped projects come to financial closure. Such a rating is valuable for a country because it provides worldwide access to institutional pools of capital and lowers capital costs. Institutional guidelines often limit investments to investment-grade instruments; an investment-grade rating allows investors to purchase project paper and stay within these guidelines. Because investment-grade instruments are viewed as less risky than non-investment grade bonds — also known as high-yield or junk bonds — they can be offered at lower interest rates, decreasing financing costs.

Individual projects also benefited from an investment-grade rating, including the Paiton I power project, discussed below. A total of four projects were rated investment grade, facilitating their sale in the United States under the 144a program. Under this program, qualified U.S. institutional investors such as mutual funds, pension funds, and insurance companies can buy and trade securities under less onerous disclosure requirements than SEC public offering requirements.

C2. The Example of Paiton

P.T. Paiton Energy Co., a limited-liability Indonesian company, was established to develop, construct, own, and operate a $2.5 billion, 1,230 MW coal-fired power plant in East Java.

Financing for Paiton. Financing for Paiton was fairly typical for a P3 power project. The project's sponsors and their financial contributions were as follows:

- Edison Mission Energy — senior debt and 40 percent equity
- General Electric Capital Corp. — 12.5 percent equity

- Mitsui & Co. — short-term debt and 32.5 percent equity
- PT. Batu Hitam Perkasa, a local partner — 15 percent equity

Together the project sponsors contributed $680 million in equity and subordinated debt, totaling 27 percent of project capital. The project sponsors were also obligated to provide up to $300 million in overrun commitments. The U.S. Export-Import Bank, OPIC, and commercial banks provided $182 billion in debt. Project debt financing also included $180 million in 9.34 percent senior secured bonds due in 2014, which made up a 144a private placement in the United States. Exhibit I-7 on the following page illustrates Paiton's financial structure.

The power purchase agreement. A power purchase agreement (PPA) for 30 years was reached with the PLN, the state-owned power company. The PPA was structured to hedge inflation, allocate currency risk to the PLN, and provide for the full recovery of project capital and operating costs, including debt service. The PPA provided for monthly capacity and energy payments denominated in rupiah and adjusted to reflect dollar/rupiah exchange-rate fluctuations. Capacity payments were based on availability, regardless of dispatch, and energy payments provided for a pass through of all fuel and variable operating costs. A letter of support issued by the Ministry of Finance facilitated the favorable power purchase contract that was reached with the PLN.

The project's electricity tariff was expected to exceed the equivalent of 8 cents/KWH, making it one of Indonesia's most expensive P3 projects.

Credit rating. S&P rated the project's bonds as BBB, citing the following project positives:

- The Ministry of Finance's letter of support
- The project's strategic importance to Indonesia's electricity sector
- A fixed-price, turnkey construction contract
- A stable prospective financial profile

However, the S&P credit rating report noted uncertainty concerning creditor rights and enforcement in Indonesia. It also noted that many private sector power projects around the world run a risk that government guarantees may prove of little value if called upon. To date, no independent power producer has had to call upon its guarantee. With Indonesia's crisis still fresh in the minds of international investors, the investment world will be closely monitoring the government's commitment to fulfilling its obligations under the Paiton project.

C3. Problems with the Previous Infrastructure Program

Indonesia's previous private participation in infrastructure program was characterized by the following constraints:

- The program lacked a regulatory framework.

- The program did not encourage competition among potential private sector sponsors, resulting in high tariffs for consumers.

Exhibit I-7. Paiton Energy Company Financing

- Government officials lacked experience in identifying, structuring, tendering, marketing, and evaluating potential P3 projects.

- The program was not transparent, encouraging perceptions of favoritism and unfair dealing.

- Donor participation and financing, while needed, was constrained by the lack of transparency.

Due to these problems, a number of leading companies refused to take part in the program. As a result, the public did not receive the benefits of the lowest possible price or best service. In early 1997, the Indonesian government began to change its framework for P3 projects. The government's revised policy for public-private partnerships is reflected in Keppres 7/98, which, while not perfect, is a step in the right direction. It calls for better systems to identify, structure, and competitively tender P3 infrastructure projects.

D. The Impact of the Crisis on P3 Project Financing

Indonesia's crisis was triggered in part by a financial contagion that spread outward from Thailand, as imbalances in Thailand's current accounts led to a massive depreciation in the baht. Other currency crises, accompanied by the economic problems that result, soon spread to other Asian countries previously held up as development models. Financial market analysts decided to take a closer look at Indonesia's apparent economic success. They discovered high levels of overseas borrowing, largely comprised of private, unhedged, short-term debt. Analysts estimate that less than 20 percent of corporate foreign currency debt in Indonesia was adequately hedged at the end of July 1998.

In some instances, Indonesia's apparent economic stability, especially in exchange rates, actually contributed to the unfolding crisis. To maintain a stable exchange rate during the 1990s, Indonesia set high domestic interest rates, which have hovered for the past seven years from the high teens to the low twenties. While these high rates helped maintain a stable currency, it also encouraged Indonesian firms to borrow offshore to benefit from interest rate differentials. This borrowing, which was not adequately hedged, helped set the stage for the crisis.

D1. The Link Between Financial Policy and Infrastructure Financing

Large due to the high interest rates, Indonesia's local financial sector was a marginal player in the infrastructure projects that came to fruition before the crisis. High interest rates for rupiah financing prompted infrastructure companies and other industrial and commercial firms to seek out dollar-denominated financial instruments at lower rates.

As a result, rupiah participation in infrastructure projects has been limited. For example, Bank Indonesia had a limited participation on a seven-year note at 16 percent per annum for a toll road concession. Because of the high interest rates, such loans were paid back as soon as possible through internally generated cash flow or refinancing. While such loans sometimes appeared to use longer term instruments of five years or more, almost all had put and call features that significantly cut the maturity period.

Prior to the crisis, the typical Indonesian company was borrowing in U.S. dollars at 8 to 10 percent without hedging. If hedging costs were included, the average cost of foreign capital rose above 14 percent. This was still considerably lower than local interest rates, which often topped 20 percent. With a relatively stable exchange rate — remaining at about 2,500 rupiah to 1 U.S. dollar throughout the 1990s — local companies borrowing dollars offshore saw little reason to hedge their foreign exposure.

And, as Indonesian long-term fundamentals appeared reasonably solid, most industrial and infrastructure companies and projects did not hedge their foreign currency liabilities. When the exchange rate came under pressure, Indonesian companies and the banks they dealt with faced serious, potentially catastrophic problems in servicing their debt.

D2. The Crisis Unfolds

Amid fears that Asia's currency crisis would spread to Indonesia, the exchange rate band was widened in July to discourage speculative attacks on the rupiah. In August, in response to continued pressure on the rupiah, the currency was allowed to float. The large depreciation that resulted reflected a severe loss of confidence in Indonesia's currency, financial sector, and overall economy. The crisis also revealed serious problems in the country's banking sector: underprovision, undisclosed and risky open foreign exchange and bond positions, poor credit controls, and vulnerability to runs on deposits.

In November 1997, as part of the first International Monetary Fund (I.M.F.) rescue plan, fiscal policy targeted a budget surplus of about 1 percent of GDP while monetary policy aimed at containing inflation and supporting the exchange rate. These policies strove to provide a macroeconomic framework to support efforts to restructure Indonesia's financial sector and accelerate structural reforms. In early 1998, doubts on the strength of Indonesia's commitment to the I.M.F. reform package sent the rupiah reeling once again. At one point it reached the extraordinary level of 17,000 rupiah to the U.S. dollar, before bouncing back to a level ranging between 8,000 to 12,000 rupiah to the dollar during the spring of 1998.

Since a large percentage of Indonesian company debt was denominated in U.S. dollars and most firms had not hedged this exposure, firms were suddenly faced with the necessity of earning many more rupiah than previously from operations to pay off their dollar-denominated debt. Achieving this feat in a severely depressed economy has generally proved impossible: most debt could not be paid back, which implied that many of Indonesia's leading firms were effectively bankrupt.

D3. Financing P3 Projects: Looking to the Future

Like many of its Asian neighbors, Indonesia has lost its investment-grade rating in the wake of the crisis. The hurdle rate — that is, the rate of return needed for a project to be acceptable — has increased significantly to reflect higher risk levels. The lower country rating may mean that the investment guidelines of foreign banks will preclude consideration of Indonesian projects, even those that are attractive on their own merits.

Banks that do consider P3 projects in Indonesia will now demand a higher rate of return on investment to compensate for the increased risk of doing business in Indonesia. This will be true for both equity and debt investors. However, since debt typically accounts for 60 to 75 percent of total project finance, addressing lenders' concerns will be key.

Bankers are more risk averse than project sponsors and other equity investors. For lenders, a project's upside potential is limited to the interest rate charged, while their downside risk could be the full amount of the loan. Since their potential return is low relative to equity invested, banks will only consider projects with commensurately low risk. Countries and projects that are less than investment grade — as Indonesia is now — face two possible outcomes in financing P3 projects: they will pay higher interest rates or they will be unable to access loans at *any* interest rate, rendering the project impossible to bring to closure.

To attract debt financing at reasonable rates, project sponsors and developers and the government must work together to enhance the creditworthiness of P3 projects. This task should be undertaken without undermining the shift of risk and reward to the private sector that forms the basis of a P3 strategy. As discussed in detail below, project creditworthiness can be enhanced in three basic ways: through project financing techniques to reduce risk and make the project more attractive to debt financiers; by enlisting various forms of government support; and by accessing a variety of donor support.

D4. Future Foreign Capital Flows and P3 Projects in Indonesia

Before the crisis in Indonesia, the private sector provided a growing share of Indonesia's external financing needs compared to official development assistance (ODA). In 1996 to 1997, for example, direct private sector foreign investment and other private capital was an estimated $12.7 billion on a net basis; during the same period, ODA was $5.4 billion. Before the crisis, the World Bank and Bank Indonesia projected that these figures would reach $14.4 billion and $5 billion, respectively, by 1999 to 2000.

In the wake of the crisis, foreign capital flows will be lower than projected for the next two to three years as investors regain confidence and await the new investment framework — and new framework for P3 infrastructure projects. To deal with these shifts in foreign capital flows, Indonesia's strategy must focus on three key points:

- Developing local capital markets to raise a greater percentage of long-term project financing from domestic sources. This topic is discussed in Section II.

- Devising a framework to attract foreign investment for P3 infrastructure projects and other projects. A P3 program that reflects international best practices will be a critical element in achieving this objective.

- Enhancing project creditworthiness through project financing techniques and targeted government and donor support. These techniques, which can help increase foreign financing, are examined in Section III.

Ideally, increased ODA would make up for the drop in foreign private capital. In reality, it will probably not fill the gap. Strategies are needed to leverage available ODA to attract foreign capital. In this vein, Section IV discusses the use of private sector infrastructure development funds (PSIDF) to catalyze and leverage foreign and local financing for P3 projects.

SECTION II

Indonesia's Financial Markets and Their Potential to Support P3

As noted in Section I, most Indonesian infrastructure projects with private sector participation have drawn on foreign debt financing. Reasons include the limited capacity of local markets to provide long-term financing and the lower interest rates available from foreign loans.

In this section, we examine financial markets in Indonesia in detail, analyzing the reasons they have not played a more important role in financing infrastructure. We then explore mechanisms for developing local market capacity to transform savings into investment, promote economic growth, and ultimately provide a bigger share of financing for Indonesian infrastructure projects.

A. Indonesia's Financial Markets

Even before Indonesia's financial crisis began in 1997, little of the country's infrastructure financing was raised in local equity markets. Only a handful of companies have succeeded in raising funds through listing on the Jakarta Stock Exchange (JSX), with listing requirements that include three years of operation, with the last two years profitable. Clearly, untried greenfield projects found it difficult to use the exchange to access financing. As Indonesia's currency crisis unfolded, the low market capitalization of the few infrastructure-related companies listed on the JSX became a serious handicap: now, those companies are unable to raise further capital on the exchange.

In Indonesia, high rupiah interest rates, lack of a bond market, and transparency and rule of law concerns, especially regarding bankruptcy law and enforcement, have all contributed to the nation's dependence on foreign funding. These factors have caused traditional players in the debt market — insurance and pension funds, commercial banks, and other institutional investors — to shy away from long-term products. Attractive short-term investments at high interest rates, coupled with the absence of a developed yield curve and higher interest rates for long-term investments, has made it difficult to foster an Indonesian bond market or long-term instruments.

With currency risks dramatically highlighted by recent events, building a local debt market to support infrastructure projects is essential, especially for projects with revenue largely in rupiah. Training for local commercial bankers on proper project financing techniques is needed to cultivate this funding source. Over the medium to long term, raising financing through an initial public offer of shares (IPO) would allow the private sector to participate in infrastructure. This could be facilitated by special exemptions allowing infrastructure-related companies to list before three years of operation have passed as well as permitting listed companies to issue financial products such as convertible bonds, discussed below.

A1. The Equity Market

Local public and private equity markets for infrastructure projects are thin in Indonesia. As the risks appear to outweigh rewards, venture capital plays an insignificant role in funding infrastructure. Private

participation in infrastructure is sparse among local affiliations and conglomerates. Uncertainty over tariff setting, coupled with inexperience in valuing and managing infrastructure projects, are some of the reasons that explain the reluctance of local groups to invest in infrastructure development and management.

To avoid risks, local groups secure memoranda of understanding and concession arrangements with ministries and local governments and seek out foreign joint venture partners to provide needed capital and technical expertise. Many local partners with a limited know-how and experience in infrastructure projects expect foreign partners to subsidize paid-up capital requirements. Foreign partners must secure additional funding needs from abroad since domestic long-term financing is not available and local partners cannot easily access foreign debt markets.

Public equity raised through IPOs has been meager relative to the infrastructure capital requirements of Indonesia's repelitas (five-year development plans). Six infrastructure-related companies are listed on the JSX: Citra Marga Nusaphala Persada (toll roads), Humpuss Intermoda Transport (various transportation), Steady Safe (various transportation), Telkom (telecommunications), Bukaka (telecommunications, transport, power), and Centris (taxis). The market capitalization of these six companies is shown below in Exhibit II-1. With no major IPOs slated for the near future, the expected privatization of several state-owned enterprises (BUMN) will likely capture much of the new capital raised through this channel, assuming that the BUMNs are appropriately priced.

Exhibit II-1. Market Capitalization of Firms on JSX

Company	Market Cap: Rp Billion	Equivalent in U.S. $ Million
CMNP	1,400	140
Humpuss	292	29
Steady Safe	37	3
Telkom	37,333	3,733
Bukaka	52	5
Centris	124	12

Note: Exchange rate 3/5/98: U.S. $ 1 = Rp 10,000

Steady Safe has posed particular problems, having defaulted on a $200 million loan from the Hong Kong merchant bank Peregrine, which caused the bank to go bankrupt.

As noted above, JSX listing rules require three years of operation, with the last two years profitable. This has limited the number of infrastructure companies raising funds through IPOs, as many do not produce profits during their early years. As a result, greenfield projects in Indonesia have been unable to source funds through public equity.

The Surabaya Stock Exchange (SSX), more flexible than the JSX on listing requirements, has served as a back door for JSX listing, as one could easily switch boards after a company meets JSX requirements. However, raising substantial amounts of capital through this highly illiquid exchange has proved difficult for most companies.

A2. After the Crisis

Since the crisis began in mid-1997, rupiah interest rates have gone as high as 150 percent; at the time of this report, rates hovered at 40 to 50 percent. The rupiah's volatility and the inflation that results from lifting subsidies will keep interest rates high over the short to medium term. With liquidity tight, the market continues to await the outcome of the central bank's attempt to streamline the banking system. Given this situation, the local debt market may not be a likely immediate source of infrastructure financing.

If the effects of the crisis begin to wane soon, the local debt market will provide a good funding source for projects. With the currency risk concern, local rupiah financing is preferable to foreign borrowing to the extent that interest rates remain reasonable.

The development of local financing is predicated on a number of factors: the existence of an actual market for these instruments; the market's understanding of instruments' risks and appropriate pricing; proper incentives in the form of credit enhancement and policy changes to make issuers more creditworthy; and the eventual development of a yield curve to encourage investors to purchase long-term instruments.

Given recent adverse market events, it will not be easy for listed companies to raise additional funds over the short term. Listed companies cannot attract significant new equity through current market capitalization, and the current economic environment precludes raising additional equity higher than companies' market value.

To attract mezzanine financing — financing situated between senior debt and equity in terms of expected risk and return — these companies can issue convertible bonds. Convertible bonds, a kind of corporate bond, gives holders the right, to buy the company's common shares at a predetermined price. This instrument gives potential investors the security of interest income as well as the opportunity to benefit from any upward movement in the company share price. These bonds, though, cannot be used for listed companies since they can potentially dilute the holdings of current shareholders. A company that needs to raise additional equity must instead use a rights issue, which does not guarantee that the company receives all the capital it requires, since shareholders may choose not to participate.

Another way to raise capital is to allow infrastructure-related entities with a certain minimum paid-up capital — for example, $50 million — to list right away. This structure could attract venture capital firm participation, since the risk of investment exit is lessened with a listed company.

A3. The Debt Market

Investment rating agencies Moody's and S&P have downgraded Indonesia's paper to non-investment grade as a result of the economic crisis. The rupiah's currency risk was downplayed by international capital markets for the past six years because of the rupiah's managed 4.7 percent depreciation against the U.S. dollar. Today, with the loss of over 70 percent of the rupiah's value, U.S. dollar investments are having difficulties producing good rupiah profit streams. With currency risk at the forefront of every investor's mind, the rupiah's increased risk will raise the hurdle rate required for infrastructure projects.

Local banks marginally participated in infrastructure financing through small U.S. dollar loan syndications. But high local interest rates — hovering from the high teens to the low twenties for the past seven years — have kept Indonesian banks from full participation. There are several possible explanations for the high rates: a true inflation rate that is higher than the official consumer price index, a liquidity crunch stemming from Bank Indonesia concerns over possible inflation, and the hidden costs

of banks' non-performing loans. Indeed, a combination of these factors probably explains the persistence of Indonesia's high interest rates. Even before the crisis hit, substantial declines in interest rates were not on the horizon. Exhibit II-2 below shows recent commercial bank deposit rates.

Exhibit II-2. Commercial Bank Time Deposit Rates

Year	1 mo. %	3 mos. %	6 mos. %	12 mos. %	24 mos. %
1992 December	18.3	19.5	20.2	21.1	20.6
1993 "	13.4	14.5	15.1	16.3	18.3
1994 "	12.4	12.6	12.4	13.0	15.0
1995 "	16.7	16.8	15.9	15.0	14.5
1996 "	16.4	17.0	16.8	16.7	15.1
1997 "	25.4	23.9	17.0	15.9	15.5
1998 March	30.0 est	n/a	n/a	n/a	n/a

Source: Bank Rakyat Indonesia

The exhibit demonstrates the absence of a defined yield curve promoting long-term financial instruments as well as the high interest rate environment that has prevailed in Indonesia for some time.

The bond market and insurance and pension funds. High interest rates discussed above, largely explain the absence of a healthy bond market in Indonesia. Although bonds are issued and listed on the SSX, these bonds are not traded. The resulting lack of real liquidity makes the existence of a bona fide bond market questionable. Traditional bond market players — institutional investors and insurance and pension funds — have little incentive to buy long-term bonds, as the above interest rates table demonstrates. Bonds are mostly bought by newly established mutual funds that do not pay taxes on the interest income earned. To resolve this issue, tax exemptions for infrastructure-related instruments — priced to account for their inherent risks — should be explored in greater depth.

Other factors underlying the lack of a true bond market in Indonesia is a lack of transparency and tested bankruptcy laws. With local and foreign creditors increasingly facing defaulting clients in the aftermath of the crisis, concern over the lack of bankruptcy regulation has escalated.

B. Local Infrastructure Financing: A Medium-Term Strategy

Developing robust capital markets to channel savings into productive investment will play a key role in financing infrastructure and commercial and industrial activities in Indonesia. Important linkages exist between infrastructure financing, capital market development, privatization of state-owned enterprises, and development of private pension plans, as shown in Exhibit II-3 on the following page. Using these linkages as a base for building a medium-term growth strategy for infrastructure financing can also produce significant short-term benefits.

Exhibit II-3. Linkages Supporting Infrastructure Project Financing

While the design of such a comprehensive, integrated strategy is beyond the scope of this report, certain elements are highlighted below.[1] There is a symbiotic relationship between capital markets and infrastructure financing. Capital markets deal in long-term instruments like stock and bonds. Perhaps more than other types of financing, infrastructure financing requires long-term maturities, because the projects are often long.

In the United States and United Kingdom, the need to finance the major infrastructure needs of the late 19th century — including railroads, canals, and utilities — gave rise to private capital markets. In contrast, most infrastructure in emerging markets has been financed by governments with donor support since World War II, hindering the interlinked development of infrastructure financing and capital markets that took place in the 19th century. P3 projects provide an opportunity to partially address and correct this deficiency, but it will take time.

If done properly, privatization improves both the micro- and macroeconomic environment for investment, growth, job creation, and capital markets. This process is shown in Exhibit II-4 on the following page. In addition to making SOEs more efficient and productive, privatization of state-owned enterprises also has a beneficial impact on capital market development, as selling SOEs on local capital markets increases market capitalization, depth, and liquidity. Using broad-based techniques to privatize SOEs helps promote public awareness of the benefits of privatization, development, capital markets, and personal participation in markets as shareholders. Participation and awareness can also help promote mutual funds and fund management development.

To support privatization and spread its benefits, privatization transactions should be structured to benefit capital markets whenever possible. At the time this report was issued in mid-1998, plans were being developed to sell additional shares in several of the six state enterprises listed on the stock exchange. According to the plan, shares for those companies — PT Telecom (domestic telecommunications), PT Indosat (international telecommunications), and PT Semen Gresik (cement production) — would be sold by end of the current fiscal year.

The I.M.F. program offered a good opportunity to begin privatizing SOEs in Indonesia, calling for draft legislation to privatize state banks by June 30, 1998. It also called for the Government of Indonesia to establish a clear framework and transparent process for privatizing government assets by September 1998, including developing criteria for privatizing, restructuring, or closing enterprises. The I.M.F. program should help promote foreign portfolio investment, with a beneficial impact on the JJX. Indonesia is scheduled to remove the 49 percent limit on foreign investment in listed companies by September 1998.

The development of private pension funds is another key component of a multifaceted strategy to promote capital markets and finance infrastructure. Like most countries, Indonesia's public social security system is a pay-as-you-go system. Such systems tend to eventually run into solvency problems once rising affluence and shrinking birthrates cause demographics to shift toward an older population, with fewer workers to support retirees.

[1] A fuller discussion of this strategy is found in Michael P. McLindon's *Privatization and Capital Market Development: Strategies to Promote Economic Growth*, Westport, Conn: Praeger/Greenwood Publishing Group, 1996.

Exhibit II-4. P3 Project Impact in the Economy

Developing private pension plans early in the 21st century will help avert this looming budgetary and macroeconomic crisis, while providing a more secure retirement for current workers. Pension development will also stimulate capital markets, needed to provide infrastructure financing.

Diversification, an underlying principle of good portfolio management, requires a variety of asset classes, including equity investments and corporate bonds, in addition to government paper. Almost all public pension systems use government paper exclusively, failing to meet the diversification rule. They also tend to provide poor — even negative — returns, as government bonds pay low interest rates that often fail to keep pace with inflation.

Compared to public pension systems, private pension plans are better positioned to diversify by investing in equity and corporate bonds. These plans are a logical destination for P3 infrastructure project securities. With long-term horizons, pension plans can afford to invest prudently in equity, which typically has higher long-term returns that other securities; though more volatile over the short term. Pension plans' long-term investment horizons correspond well to the long-term financing requirements of infrastructure projects. Another private pension plan strength is professional management. With their careful evaluation of markets to identify attractive securities, plan managers help capital markets become more efficient and better able to provide the financing that infrastructure projects need.

Clearly, capital market development, infrastructure financing, SOE privatization, and private pension development are interrelated, complementary activities with a range of positive micro- and macroeconomic effects, as demonstrated in Exhibit II-4. Work in all of these areas is necessary to channel savings into productive investment, creating jobs and promoting economic growth.

SECTION III

Credit Enhancement Strategies for Financing Infrastructure in Indonesia

In view of Indonesia's current crisis and the constraints previously identified, how can P3 projects obtain financing?

While implementation will be challenging, the answer is straightforward. Means and techniques to finance P3 projects have been developed in other non-investment grade countries with weaker economic fundamentals and long-term prospects than Indonesia. P3 projects can be financed in high-risk, low-income countries provided they are well structured, with strong sponsorship and political commitment. The challenge will be to adapt proven techniques for the Indonesian context.

In the wake of the crisis in Indonesia, the key to financing infrastructure will be *credit enhancement* — that is, measures to improve the credit strength of projects to attract debt financing at reasonable interest rates. Credit enhancement consists of innovative approaches to project structuring and financing that address investor concerns, especially the apprehensions of debt capital financiers over perceived increased country risk.

Project financing techniques, government support, and donor support are the three pillars of credit enhancement. Three key groups correspond to these pillars:

- *Project financing techniques* — Private sector equity and debt participants in projects
- *Government support* — the host government, which can provide a menu of support measures
- *Donor support* — institutions such as USAID, Asian Development Bank, International Finance Corporation, Multilateral Investment Guarantee Agency, and World Bank

The role of these three groups in financing infrastructure projects is examined below.

A. The Rationale for Credit Enhancement

The term *credit enhancement* is used in this document to signify the measures taken by a project's equity participants — including project sponsors, developers, and other owners — and other parties such the government and various donors to improve a projects' bankability by enhancing its creditworthiness.

There are a number of prerequisites to credit enhancement, beginning with a sound, transparent P3 program. Project identification and structuring that addresses investor concerns is a must, along with a fair and transparent tendering process that encourages the participation of leading private infrastructure providers. With good sponsors and operators, projects are better able to obtain debt financing at favorable terms. Exhibit III-1 on the following page illustrates the steps to P3 project financing. These steps build on the base of a sound P3 program that reflects political will and commitment as well as international best practices.

Even with these factors in place, sponsors may not be able to secure the debt financing required to bring a project to financial closure: a potentially good project may founder because the country is perceived as high risk. How can these countries attract financing for P3 infrastructure projects?

Exhibit III-1. The Steps to Building Infrastructure Project Financing

In emerging market countries, turning to local financial markets is often not the answer. In the caseof Indonesia, financial markets are still in the early stages of development and cannot provide the amounts and maturities of financing required. Over the medium term, however, experience from other countries has demonstrated that local financial markets must play a significant role in P3 project financing to ensure robust, sustainable economic growth.

Assessing local and foreign sources of equity will remain possible in Indonesia, depending on individual projects, sponsors, and consortium members. However, equity investors will hesitate to incur the considerable start-up costs of a P3 project unless they are confident that their project company can attract the required debt financing.

One option is for the Government of Indonesia to provide grants, subsidies, and even sovereign guarantees to P3 projects. But the crisis has tightened the government's budget, limiting its ability to assist. Moreover, providing subsidies and guarantees undermines the larger objective of P3 programs: to transfer infrastructure investment costs and risks to the private sector.

A related issue is financing P3 projects in municipal services, especially water. Centralized decision making and investment has hindered the development and creditworthiness of municipal financing. Municipal financing, expected to develop rapidly in the early 21st century, will benefit from private participation in municipal P3 projects. Private participation in financially attractive municipal projects helps ease the burden on municipalities, which must finance projects that cannot attract private participation.

B. Credit Enhancement Options

B1. Private Sector Project Financing Techniques

The first level of credit enhancement — project financing techniques — is carried out by private sector parties representing a project's equity and debt interests, with possible government agency involvement. While the private sector participants will actually use these techniques, P3 Center staff should be familiar with them, especially those techniques — such as escrow accounts — that may involve government agencies.

Lenders must evaluate each project to determine creditworthiness and ensure that it can service its debt as planned. This is unlike making a loan to an industrial enterprise, for P3 projects are *greenfield* projects — projects with no track record. A P3 project's credit strength lies in the equity sponsors have at risk, the project's expected cash flow, and the value of any project assets.

B1a. Project Priorities

Reducing risk and enhancing P3 project creditworthiness starts with emphasizing the following qualities in selecting and structuring projects:

- *Small projects*. Other factors equal, small projects are preferred in a risky environment. The logic is clear: small projects put less money — both debt and equity — at risk. In Indonesia, many large projects in the power and telecommunications sectors have already been carried out, satisfying current demand levels. Smaller projects provide the opportunity to introduce private sector participation in newer infrastructure sectors such as water and other municipal services, ports, regional airports, and other transportation projects. Small projects can illustrate the best practice techniques of the new P3 program to government agencies, private firms, and the

public, offering an opportunity to attract local private sector equity.

- *Fast payback periods*. Invested capital payback timing is also important. The faster money can be paid back — cellular projects, for example, provide fast payback — the lower the risk. With cellular markets currently saturated, few projects can clearly produce faster paybacks in Indonesia. However, solid waste collection projects require relatively little capital and can be up and running fairly quickly. Such efforts, often small, are a good way to introduce P3 projects in Indonesian municipalities.

- *High equity participation.* According to the IFC, the average project debt-equity ratio of 58/42 in risky countries is lower than the norm of 70/30 in less risky countries.[1] Relatively high equity levels demonstrate increased sponsor commitment to projects, reducing the project risk profile and the debt financing required. In Indonesia, small projects that attract significant local equity can demonstrate P3 program benefits at the grass roots level while offering Indonesian private sector sponsors and equity investors an opportunity to get involved in the program.

- *Local debt financing.* In risky countries, foreign sources typically finance two-thirds of a project's costs, according to the IFC. This reflects the fact that local capital markets in emerging market countries are less well developed that those in developed market countries. The down side is that projects with high levels of foreign debt that generate local revenue are devastated by currency fluctuations, as demonstrated recently in Indonesia and other Asian countries. To avoid a recurrence, governments must develop local capital markets to support infrastructure, a subject examined in Section II. While Indonesia should begin now to develop local financing sources, progress will be limited over the next few years. Therefore Indonesia must continue to improve its foreign investment environment, as highlighted in the discussions on government and donor support later in this section.

- *Foreign exchange generation.* Projects that generate significant foreign exchange — such as international port and airport projects — avoid the most painful consequence of the Asian crisis: the sharp depreciation of local currency. Indonesia has a great need to expand port facilities and services; port projects could be an excellent way to get the foreign private sector to return to Indonesia.

B1b. Finance Techniques

After project selection and structuring, the techniques described below are useful tools for private sector participants, who should understand their use in attracting and fine-tuning project financing.

- *Escrow account.* An escrow account gives greater assurance to commercial lenders that interest and principle on loans will be repaid. Project agreements frequently stipulate that revenues generated by a project be deposited directly into an escrow account, usually offshore. The escrow account is then used as a reserve to ensure project debt servicing. Escrow accounts will play an increasingly important role in post-crisis Indonesia. The government should understand the need for the accounts and realize that they enhance foreign P3 project financing.

- *Mezzanine financing.* Mezzanine financing involves the use of financial instruments that fall between the risk-return parameters of equity (high risk, high return) and senior debt (low risk,

[1] *Financing Private Infrastructure*, International Finance Corporation, 1996.

low return.[2]) As described in Exhibit III-2 on the following page, mezzanine financing has a medium risk, medium return profile. Such financing benefits P3 projects because its risk-return parameters can attract lenders with preferences matching this type of risk and return, increasing available financing for projects. Mezzanine financing includes subordinated debt, convertible subordinated debt, equity warrants, and preferred equity, described below:

- *Subordinated debt* is debt with a claim on cash flow — and assets, in the event of liquidation — that is junior to senior debt. (However, subordinated debt supersedes common equity in claims). In return for lower credit quality, it receives a higher interest rate than senior debt. As explained in Section IV, a private sector infrastructure development fund can be set up to onlend official development assistance to catalyze and leverage private sector financing. Such funds can be structured as a type of subordinated debt, allowing private sector financiers to be repaid quickly in a project's early years.

- *Convertible debt.* Convertible debt gives its owner the right to exchange debt by a certain time for a predetermined amount of equity at a fixed price. Until conversion, convertible debt carries the right to stipulated interest payments, repayment of principal on maturity, and a claim on cash flow and assets ahead of equity. Before conversion, the convertible debt holder receives interest payments that are almost always higher than dividends. If the project is successful and the actual worth of the equity is greater than the conversion price, the holder benefits from upside appreciation in the price of equity.

- *Equity warrants.* Equity warrants are long-term options that give the holder the right to purchase common equity at an established price within a specified period of time. This enables the holder to benefit from the upside potential of a successful project. They are often given to subordinated debt holders to lower the interest rate paid.

- *Preferred equity*. Preferred equity is a special class of equity with priority over common equity in receiving dividends.

Mezzanine financing, local and foreign, can be a useful tool for attracting financing for P3 projects. Current Indonesian regulations barring convertible bonds should be reviewed in light of the need to develop financial incentives for local participation in P3 project financing. Also, the use of a private sector infrastructure development fund, discussed in Section IV, can help create a type of subordinated debt that enhances private sector equity and senior debt.

C. Government Support

The government can provide a range of support to public-private infrastructure partnerships. Below we describe several government support options. As governments frequently develop new

[2] This section draws on a longer discussion of mezzanine financing in "The Logic of Mezzanine Capital in Asian Infrastructure," David Bussman, Project Finance International, 1997.

Exhibit III-2. Risk and Return for Different Types of Capital in P3 Projects

support mechanisms, this menu should be seen as illustrative, not definitive.

The term *government support* has several meanings. In some contexts it means general support for the P3 approach to infrastructure. Governments can provide two types of support to P3 projects: P3 program support and P3 project support.

P3 program support, examined in detail in this report, refers to the government's implementation of a P3 program that is fair and transparent and reflects international best practices. It also refers to the application of these principles to individual projects through contract enforcement and dispute settlement on an impartial basis.

P3 project support refers to specific measures that the government provides for economically beneficial projects to ensure that the private sector is willing to undertake efforts on a P3 basis.

The importance of P3 program support from the government is simple: without a best practices framework, leading local and foreign sponsors may refuse to spend resources on developing proposals. This could mean that the project fails to reach financial closure because potential lenders lack confidence in project sponsors; alternatively, lenders may refuse to invest due to the lack of credible government support for private participation. The point bears restating: *the stronger the government support for the P3 program, the less need for support of individual projects.*

Framework for government support. Government project support can be easily misused. The government should only support a P3 project after establishing that its economic benefits cannot be realized solely through private investment. While considerations for support are complex, two basic variables should be evaluated: the attractiveness of the project to potential financiers — a project's *financial attractiveness* — and the *economic attractiveness* of the project to the country. Exhibi-3 on the following page provides a framework for evaluating the need to provide government support, plotting the suitability of support in relation to the two key variables.

To measure a project's attractiveness to the financial sector, analysts must measure project returns at market rates for private sector participants. To evaluate economic attractiveness, the economic rate of return to the country is measured using true economic or shadow prices. Market prices and true economic prices often differ due to the impact of taxes, artificially low tariffs, overvalued exchange rates, labor force rigidities, and other distortions.

Exhibit III-3 describes the following four scenarios for project economic and financial attractiveness:

- Economic and financial attractiveness negative: These projects, clearly not viable, should be eliminated during identification and screening. These projects are *white elephants*.

- Economic attractiveness negative, financial attractiveness positive. These projects, which misuse government support, typically come to fruition because of political factors. Such projects are the *pork barrel*.

- Economic and financial attractiveness positive. These projects are attractive to both the country and the private sector. While these efforts need the usual program and non-financial project support, they do not need government financial support. Projects in this quadrant are *beautiful swans*.

Exhibit III-3. Economic and financial Return Profiles for P3 Projects

- Economic attractiveness positive, financial attractiveness negative. These are the projects that can properly benefit from government support and creative project structuring. While they stand to benefit the country economically, current financial dynamics do not attract the private sector: for example, a water project is economically attractive, but artificially low tariffs do not attract private sector participation. These projects are *ugly ducklings* that, with the appropriate government support and structuring, may become beautiful swans.

To help screen projects, the P3 Center will gauge project economic and financial viability at the pre-feasibility level. Many projects seem to need support, but private operators should first investigate improved management techniques, new technology and investments, and other steps to make projects financially attractive without government support. In a P3 approach to infrastructure, the government's role is to secure the desired service at the lowest possible cost to consumers and the national budget, if support is indeed needed. It is not always advisable for the government to commit to defined levels of support during the tendering process.

Defining government support is often best carried out during competitive bidding. While the process will vary, tender documents can request bidders to submit their lowest bid — for example, to propose a water tariff in cents per cubic meter. Bidders would then be required to calculate the net present value of the government support required to provide water service at that price. In this way, the case for government support is subject to competitive forces. One of two basic outcomes will take place: government support is not needed, as the lowest bid does not require support, or an acceptable tariff is realized with the lowest terms of government support.

As it involves a number of different mechanisms, government support for projects can be hard to compare. Some forms of support can involve direct costs to the government. Other forms have no cash value and little opportunity cost, such as unclaimed land. Yet other forms of support — a performance guarantee, for example — involves contingent costs. Nevertheless, means can be devised to make comparisons as fair as possible. The point remains that the government should not commit to a specific type or level of support, but rather subject this variable to the competitive forces of the tendering process, allowing a least-cost solution. Below, we describe various government support measures provided in past P3 projects.

C1. Tax Holidays

Tax policy is an area in which the government can improve the financial dynamics of P3 projects. Lowering taxes and establishing tax holidays for P3 projects can increase project cash flow and improve credit strength. Allowing capital equipment, machinery, and spare parts to be imported tax- and duty-free is another way for the government to attract investors by improving projects' financial

profiles.

Under the traditional model, infrastructure service tariffs are generally below the full economic cost of provision, with the general budget bridging the gap through various taxes. Many governments fear that tariffs will increase significantly if the private sector provides infrastructure. By agreeing to reduce or postpone taxes, the government reduces the tariff that the private sector operator must charge to cover costs and make a reasonable profit. Thus, by providing tax relief, the government helps operators maintain lower tariffs. The alternative is that the operator will pass taxes along to consumers in the form of higher tariffs. Another factor to consider is that private firms often invest in rehabilitating and expanding infrastructure, reducing the government's need to raise revenue through taxes on P3 operators.

The advantages of tax holidays and reductions must be weighed against the costs of a more complex tax system. Depending on the country, it may be more advantageous to move to uniform, lower taxes across all commercial activities. Relying on P3 solutions for infrastructure needs — along with privatizing SOEs and reforming the small, targeted government that remains — can help a government move in this direction by lowering government expenditures, eventually allowing a country to lower overall tax rates.

For Indonesia, one possible strategy is to grant tax holidays over the next two to three years, when foreign investment is most needed. After that, the government could move to a system of uniform, lower taxes across the board.

C2. Providing Low-Cost Benefits and Sharing Costs

Many projects can benefit from forms of support that cost the government little or nothing. For example, many road, highway, and airport projects can be made more financially attractive by including the right to develop adjoining land and properties. To improve a road project, the government can include other sections of the highway as part of the toll road system, securing all necessary approvals and permits before contract award. In many cases, such land has insignificant opportunity costs without the project. Including property in a P3 project increases its value to the sponsor and improves credit strength from the lender's perspective. The result may be lower tariffs for consumers.

Another support option is to share project costs with the private sector. For instance, to encourage P3 solutions for regional airports — which may not be as attractive to the private sector as a major international airport — investment costs can be divided between the private sector, which would provide the terminal building, and the government, which would pay for the runway.

Low-cost benefits and cost sharing, rarely used in Indonesia in the past, have the potential to enhance the credit of many Indonesian P3 projects. Structuring such mechanisms into projects would increase Indonesia's long-run attractiveness to investors, while allowing projects to benefit from resources with low economic or budgetary costs. These potentially useful tools create win-win scenarios for the government, sponsors, bankers, and consumers, and should be considered for future P3 projects.

C3. Performance Guarantees and Offtake Arrangements

In some projects, the P3 company depends on a state-owned enterprise to buy output or provide supplies. For example, in a power project, a P3 company may generate electricity and sell it to the SOE power company. Frequently P3 projects must procure fuel supplies, such as oil, from an SOE supplier. In these cases, project sponsors and lenders require power-purchase agreements from the SOE power

company to ensure they can sell power. Payments are typically based on a capacity fee designed to recover investment, fixed operating costs, and an energy fee covering variable operating costs and bonuses, along with a reasonable profit. The project sponsors and lenders may ask the government to guarantee SOE power company performance and obligations to ensure that the government will step in if the SOE power company cannot perform as promised.

In Indonesia, the power sector is fully supplied — possibly over-supplied — for the country's current needs. The government can use this lull to privatize PLN, thereby avoiding the need for guarantees when demand picks up and new supply is needed. Privatizing PLN is fully consistent with the strategy outlined in Section II to develop local capital and financial markets and spread share ownership. To do this, the government must unbundle the power sector to introduce competitive forces into as many service segments as possible.

C4. Assurances on Tariff Adjustment, Currency Exchange, and Profit Repatriation

Formula-based pricing is required for P3 project services such power or highways. Power tariffs and highway tolls are often automatically adjusted based on price indices of relevant construction materials and variable operation and maintenance expenses.

For P3 projects that generate local currency, the government must provide assurances that local currency can be converted to foreign exchange at market rates. For projects that generate foreign exchange, sponsors will ask the government to guarantee free foreign exchange repatriation.

As noted in Section I, the Paiton project provided for price adjustments based on cost and exchange rate changes. In view of Indonesia's dire economic situation, bilateral negotiations would be a sensible step to providing some relief for the PLN. Foreign investors watching the government's approach to adjusting to post-crisis realities in this project will take a dim view of any unilateral effort to abrogate project agreements.

C5. Government Subsidies and Equity Participation

In general, government subsidies and equity should be avoided. Subsidies, which represent a return to the old way of providing infrastructure, rarely motivate private sector operators to improve efficiency and reduce costs. Government equity participation in P3 projects is also highly undesirable. It runs counter to the purpose of P3 programs: get the government to move out of project operation — which the private sector can do better — and focus instead on regulation. Moreover, government equity stakes often *reduce* rather than enhance project creditworthiness. Lenders rightly fear that the same practices that resulted in poor performance under the traditional government-led approach to infrastructure will creep back in if the government has a say in day-to-day operations. If the government must make an investment contribution, it should be repaid as a debt holder or through participation in revenue-sharing.

In the past, government subsidies and equity participation often favored those close to the former regime in Indonesia. These discredited practices should be avoided as Indonesia moves to a new regime that is fair and transparent.

D. Donor Support

Once projects have been tendered, evaluated and awarded to a sponsor, the task of finding debt financing begins. The International Finance Corporation (IFC), which is the private sector-lending arm

of the World Bank Group, and the private sector window of the Asian Development Bank (ADB), play a pivotal role in bringing projects to financial closure in less than investment-grade countries in Asia. The IFC and ADB make both equity and debt investments in projects, often syndicating loans with commercial banks, known as “B” loans. Interest rates for these loans are lower than typical commercial bank loans because the loans run less risk of rescheduling. Exhibit III-4 on the following page illustrates the loan syndication process.

The success of a number of IFC- and ADB-assisted projects in Asia has catalyzed the

Exhibit III-4. IFC and ADB Loan Syndication in P3 Project Financing

development of project finance in a number of countries where risk is too high to attract purely commercial investment. Once financed and commercially successful, these cooperation projects have provided significant demonstration effect, increasing commercial bank financing forsubsequent projects. Discussions with IFC and ADB officials indicate an interest in playing a similar role in Indonesia. In the past, participation of the two institutions in Indonesia's cooperation efforts was limited by the program's lack of transparency and competition. Once Indonesia's program attains the openness envisioned by the presidential decree Keppres 7/1998, possibilities for IFC and ADB involvement will improve markedly.Like the IFC, the Multilateral Investment Guarantee Agency (MIGA) is part of the World Bank Group. MIGA supports investment by providing political risk insurance to foreign investments in emerging market countries. It covers four basic types of risk in foreign investment: expropriation, war and civil disturbance, currency inconvertibility, and breach of contract and denial of justice.

The World Bank itself also plays a key role in enhancing the bankability of P3 projects. In several countries, the bank has channeled loan funds to a private sector infrastructure development fund (PSIDF), which make loans to P3 projects. These loans typically constitute 20 to 30 percent of project debt financing, with repayment terms longer than commercial bank loans. This assistance helps projects structure favorable financing packages and repay commercial bank loans quickly. The result is a reduction in commercial bank risk that lowers interest costs for borrowers and increases bank interest in participation in projects, particularly those with IFC or ADB backing. The World Bank can also provide guarantees to P3 projects that improve project bankability. However, guarantees are generally time-consuming to use, making PSIDF loans more immediately attractive for infrastructure financing. Section IV of this report discusses the design of a PSIDF for Indonesia.

The PSIDF approach has a number of benefits over the World Bank's traditional practice of lending funds to governments, which then carry out and manage projects through ministries. From the government's perspective, a major benefit is that the PSIDF approach eliminates the need for host-country government contributions to project costs. Infrastructure projects financed under the traditional model are often delayed because a government cannot provide its share of project costs while cutting spending, often under an I.M.F.-mandated program. Another benefit is that channeling World Bank loans through cooperation projects helps leverage commercial bank financing.

These advantages are in addition to the clearest benefit of the PSIDF approach: The private sector provides infrastructure and services more cheaply and efficiently than the government.

SECTION IV

Design of a Private Sector Infrastructure Development Fund

This section discusses the design of a mechanism for using official development assistance from the World Bank, the Asian Development Bank, USAID, and other donors and concessional financiers for P3 infrastructure projects in Indonesia.

Private sector infrastructure provision is superior to traditional donor-to-government assistance in several ways. The P3 approach reduces the financial burden on overly indebted governments; it also encourages efficiency and technological innovation by involving the private sector in areas where it has competitive advantage over the public sector. With debt repayment schedules to meet and the need to make a risk-adjusted return on investment, the private sector operator has a keen interest in seeing that a project operates smoothly and delivers services efficiently.

In countries like Pakistan and Jamaica, the World Bank and other donors have created funds to channel development assistance to the private sector for infrastructure development projects, including BOT-type efforts. In Indonesia, a private sector infrastructure development fund (PSIDF) could provide finance to support private sector involvement in providing much-needed infrastructure in water supply, wastewater, ports, roads and bridges, mass transit, solid waste management, and other sectors included in the Government of Indonesia's guidelines.

A. Private Sector Infrastructure Development Fund

Development assistance for private sector-led infrastructure in Indonesia can accomplish the following:

- Catalyze private sector development, ownership, and management of infrastructure
- Increase local long-term financing and overcome post-crisis difficulties in accessing foreign long-term financing for infrastructure projects
- Reduce the government's obligation to provide counterpart funds for projects

Exhibits IV-1 to IV-4 on the following pages illustrate infrastructure financing options and the role of a PSIDF. Exhibit IV-1 depicts traditional infrastructure financing, in which the government designs, constructs, finances, manages, operates, and regulates infrastructure projects. Donors assist this process by providing loans to governments. In the P3 approach to infrastructure financing, shown in Exhibit IV-2, the government — still playing a critical role in program support and monitoring — is complemented by the private sector, which bids for the right to develop projects. In this approach, risks, responsibilities, and returns are better divided along the lines of the competitive advantages of government and private sector.

Donors continue to play a useful role in the P3 approach, their assistance serving as a catalyst for attracting private sector participation, especially in risky countries. One way donors can accomplish this is by onlending to a PSIDF that provides debt and guarantees to leverage private sector financing.

Exhibit IV-3 illustrates the potential of PSIDFs to increase available financing by leveraging scarce resources to support P3 project financing and provide credit enhancement. In Exhibit IV-4, the operation of a PSIDF in Indonesia is shown. Providing a focus for donor support and funding, the PSIDF would work in tandem with the other pillars of credit enhancement: project financing techniques and government support.

Exhibit IV-1. Traditional Approach to Infrastructure Financing

Exhibit IV-2. P3 Approach to Infrastructure Financing

Exhibit IV-3. PSIDF: Leveraging Scarce Resources to Increase Infrastructure Financing

Exhibit IV-4. PSIDF Operations in Indonesia

A1. Donor Involvement in a PSIDF

How reasonable is it to expect donors to participate in such a fund?

The World Bank is limited by its charter to loans to sovereign governments or loans covered by a sovereign guarantee. It has not made direct loans to BOT projects, which lack sovereign guarantees. However, the World Bank has worked with donors like USAID to find creative ways to assist member countries in implementing BOT projects. In Pakistan, for instance, the World Bank and USAID helped establish a $520 million private sector energy development fund for long-term loans of up to 30 percent of the cost of qualifying energy projects, including BOT projects. The bank also provides assistance for P3 projects by conducting sector studies, carrying out studies in Turkey, Pakistan, and the Philippines to determine the feasibility of P3 projects in the power sector. With a PSIDF in Indonesia, the bank would likely provide feasibility study funding for P3 projects.

For USAID, a PSIDF in Indonesia would substantially leverage agency resources. By providing assistance to the government to get a PSIDF up and running, USAID would in effect be the architect of the vehicle for sustainable P3 financing. The PSIDF's presence would allow other donors to efficiently target financial resources for infrastructure development in Indonesia.

The PSIDF could also serve as a useful mechanism for using USAID's new credit development authority, which provides for the transfer of up to $7.5 million in DA, ESF, and SEED act funds to cover the subsidy costs of direct loans or loan guarantees used for any development purposes under the Foreign Assistance Act.

A2. Official Development Assistance Flows to Indonesia

Before the crisis, analysts projected that the private sector would provide a growing share of Indonesia's external financing needs, as shown in Exhibit IV-5.

Exhibit IV-5. Sources of External Financing for Indonesia Projected Before Crisis (in $U.S. billion)

Financing Sources	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000
Foreign Direct Investment (net)	5.4	6.5	6.7	7.6	8.5
Other Private Capital (net)	4.5	6.2	6.0	6.0	5.9
Official Development Assistance	5.7	5.4	5.6	5.2	5.0

Source: World Bank

Though viewing the private sector as an increasingly important source of financing for Indonesia, the World Bank saw a continued need for development assistance. The bank cited the following reasons for its assessment:[1]

- Development assistance provides virtually the only source of stable, long-term financing for public investments that cannot attract private sector involvement.

[1] "Indonesia: Sustaining High Growth with Equity," the World Bank, 1997.

- Private sector financing is only available in a handful of infrastructure sectors.

- A heavy reliance on private financing for public investments carries risks.

Post-crisis foreign investment and capital flows to Indonesia will certainly be lower than the projections above. Development assistance will be needed to return growth rates to former levels. A PSIDF mechanism, complemented by other credit enhancement techniques, is an efficient way to accomplish this while addressing the above concerns. For projects that are not attractive to the private sector, financing techniques, coupled with government support, can help develop better project profiles. (These projects presumably pass the test of economic feasibility described in Section III; the issue, then, is to structure the projects to attract private sector participation.)

Development assistance channeled through a PSIDF can help catalyze and leverage private sector finance. If properly implemented, such a strategy can help foreign capital flows rebound to pre-crisis levels over the next few years. Properly leveraged through a PSIDF, development assistance will not need to bear the full burden of replacing foreign capital.

A3. Fund Description

The proposed fund — a multidonor private sector infrastructure development fund — would complement and help mobilize private sector capital to finance, own, and operate needed infrastructure projects.[2] The fund would assist the Government of Indonesia in increasing private sector investments under P3 arrangements to help attract private sector participation in infrastructure projects. The PSIDF could receive support from the World Bank, ADB, USAID, and other donors.

The fund would provide up to 30 percent financing for private sector involvement in infrastructure projects, including various P3 financing arrangements such as BOT, BOOT, BOO, and BT. Equity investment from project sponsors and other investors would represent at least 20 percent of project cost. The fund could also provide partial guarantees for commercial debt to increase resource leveraging.

In addition to capitalizing the PSIDF, donors could provide training, technical assistance, and equipment to help set up the fund, as well as work with line agencies to increase their effectiveness. Donors could also fund studies in private sector infrastructure participation to support the participation of foreign investors and Indonesian companies in the fund.

One drawback is that such funds take a fairly long time to set up, usually 12 to 18 months, due to the number of parties involved. On the other hand, once it is up and running, the fund will operate more efficiently than traditional donor-government efforts, since it is private sector-driven. The fund's private sector focus will help it catalyze and leverage private sector finance, overcome the lack of long-term financing, and reduce fiscal burdens on the government, all difficult for the traditional approach to achieve. In addition, the fund will serve as an extension of the P3 Center structure for P3 projects in Indonesia, as illustrated in Exhibit IV-6 on the following page.

[2] The term *fund* is not used in its legal sense. A PSIDF is a mechanism for providing nontraditional financing to infrastructure projects.

Exhibit IV-6. Institutional Structure of P3 in Indonesia

To illustrate the fund's potential impact, we can assume that Indonesia will need $60 billion in new infrastructure over the next five years if it uses a P3 approach. Further assumptions include an average project debt-equity ratio of 70/30 and an average PSIDF loan contribution of 25 percent of project debt. Under this scenario, Indonesia will need $42 billion — that is, 70 percent of $60 billion — in debt financing for P3 projects over the next five years, or about $8 billion a year. The PSIDF would contribute $10.5 billion (25 percent of $42 billion) over five years, or a little over $2 billion a year. If the PSIDF guarantee component came into effect quickly, PSIDF debt contributions could be reduced or more infrastructure financing could be leveraged.

A4. Fund Implementation

The following section examines key issues and parameters for setting up a fund. Many of the observations are largely illustrative, as decisions on specifics like interest rate, repayment period, and grace period must be based on the economics of particular projects. These decisions would be made by the fund manager on a case-by-case basis.

Fund structure. Each donor would reach a separate project agreement with the Government of Indonesia to provide funds for a common credit facility. Procedures for coordinating co-financiers would be detailed in a co-financiers' memorandum of understanding (CMU) finalized between the government and co-financiers. The CMU would outline the approval processes for fund decisions to finance eligible P3 and other projects. The memorandum would also detail processes for clearing bidding documents and approving award recommendations, reporting formats, and annual audit arrangements.

The IFC and the ADB's private sector windows, which do not provide official development assistance funds, could complement the fund by offering loans at commercial rates to firms and taking equity positions in privately owned or operated infrastructure projects.

The fund would be managed by a commercial or investment bank, selected through a competitive tender. The fund's board would include representatives from the official development assistance co-financiers, Ministry of Finance, Bappenas, relevant line agencies, and other appropriate parties. The PSIDF would have close ties to the P3 Center in Bappenas. The fund's responsibilities and tasks are illustrated in Exhibit IV-6 on the following page.

Onlending mechanism. The Government of Indonesia would onlend to the PSIDF, which would make medium- and long-term limited-recourse loans to eligible infrastructure project companies.

Guarantee and foreign exchange risk. In onlending to the PSIDF, the government would assume foreign exchange risks. In exchange the PSIDF would pay a guarantee and foreign exchange fee, enabling the government to set up its own provisions for possible foreign exchange losses. However, sovereign guarantees for loans assumed by the private sector would not be provided. A basic principle of P3 and other private participation projects is that private sector investors should not require direct sovereign guarantees for supplier credits and commercial loans. Instead, the PSIDF should assume project risks.

Onlending rates. The PSIDF would onlend project funds to eligible infrastructure project companies in rupiah and foreign exchange at market interest rates. The PSIDF could offer alternative variable and fixed rate options to project company borrowers. Rates charged should cover the guarantee and foreign exchange fee for rupiah-denominated loans, as well as an adequate spread to cover other expenses.

Onlending interest rates for foreign currency loans from the PSIDF to eligible private sector entities should equal prevailing foreign loan rates to industrial enterprises. The rate should cover the costs of borrowing and operations and allow for accumulation of reserves. The cost of operations includes costs for personnel, administration, auditing, reporting, loan documentation, and supervision of project implementation.

For rupiah-denominated loans, interest rates could be based on the pool-based variable lending rate system used by the World Bank and ADB. As noted above, the government would assume foreign exchange risks under loans in exchange for a market-based foreign exchange risk fee paid by the PSIDF.

Repayment terms for onlending would correspond to the terms of the official development assistance loans and each project's economic profile. A grace period would facilitate completion of lengthy projects and support repayment of export credits and commercial loans. In allocating available funds for repayment, commercial loans and export credits obtained for project company purposes would have piority over financing obtained from the PSIDF. This implies that commercial loans would be senior in repayment to loans provided by the fund. However, the PSIDF would be *pari passu* with commercial lenders in liquidation.

The PSIDF could provide partial guarantees on the commercial debt of banks and other debt financiers. Such guarantees provide further resource leveraging and additional credit enhancement for P3 project financing.

Eligible sub-borrowers. The PSIDF would finance technically, economically, and financially sound infrastructure projects that feature private sector infrastructure ownership or management, with a minimum equity contribution of 20 percent required from the project company. The following sectors would be eligible for official development assistance financing through the PSIDF: power, telecommunications, ports, mass transit, roads and bridges, solid waste management, water supply, and other sectors approved by government guidelines. Fund project approval would be based on the following criteria:

- The project is part of the public investment (Blue Book) program, included on the list of eligible projects under P3 guidelines, or proposed and approved in accordance with government guidelines on unsolicited proposals.

- The project complies with relevant Government of Indonesia and co-financier guidelines on environment, occupational health and safety, and procurement.

- The project company successfully negotiated implementing agreements with the government and other agreements needed for approval.

- The project company submits a detailed, bankable feasibility study.

Evaluation of subprojects. The PSIDF would review and evaluate subprojects against the eligibility criteria. If the amount of a subloan exceeds the limit agreed to by the co-financiers, they would have the option of conducting their own evaluation of the subproject.

Procurement. The procurement of equipment, materials, and services financed by the World Bank would follow bank guidelines. To use tied funds from a country donor agency, project investors would follow that agency's procurement procedures.

Disbursements. Disbursement of co-financier funds would be in accordance with the funds' respective guidelines. For successful bidders from countries eligible for financing under World Bank and ADB guidelines, contracts would be financed by the agencies in proportion to their contributions to the fund.

Co-mingling of funds. While co-mingling funds from different sources may be desirable in the long run, it would not be practical in the beginning, due to difference in donor funding mechanisms. To avoid possible delays, the PSIDF should not co-mingle funds at the time of start up. The issue can be addressed in a later evaluation once the fund is up and running.

B. Implementation Schedule

To set up the PSIDF, the following steps would be required:

- High-level consultations between Bappenas/Ministry of Finance, World Bank, ADB, and OECF
- Finalize linkages between the PSIDF and the P3 Center
- Begin developing the P3 project pipeline

Fund development could be implemented in stages. To begin, independent loans or lines of credit could be made available for the first several P3 projects. If the P3 program shows signs of developing into a sustained process, development of a formal fund could then be explored.

The first stage in fund development would include its establishment, development of guidelines for appraisal, approval, and supervision of P3 projects, recruitment of core staff, and appointment of consultants to support operations during the fund's first several years.

The second stage would involve recruiting consultants to carry out a detailed design of the fund's organizational structure, prepare an operations manual, and develop a staffing strategy. As infrastructure project financing requires specialized skills, the fund would benefit from the services of a financial institution experienced in infrastructure project financing. This could be achieved through a competitively bid contract for a commercial or investment bank to operate the PSIDF. In addition to a fixed fee, the institution's earnings would be tied to the fund's financial performance. To get the fund off to a solid start, initial contributions should include grant monies for technical assistance specialized in start ups for private sector development funds.